3. The Economics of Customer Relationships

In the imaginary world of complete resource mobility, the relationship as a phenomenon is to some extent meaningless to discuss. Relationship considerations are not particularly important if the market is assumed to work entirely in a pure exchange-centric way independently of the context. If a supplier can replace a lost deal with a new one tomorrow at no extra cost, then a customer relation perspective is rather inferior.

If, on the other hand, a buyer and a seller doing business with each other on an ongoing basis eventually and gradually adjust to the needs, wants and structure of the other party in order to gain advantage, then the situation might be quite different. If a supplier even *adapts* his machinery, products, organisation, systems, staff or other capital assets in order to meet the *specific requirements* of individual customers or segments, such resources are no longer completely mobile. Assets adapted or even tailor-made to certain relationships, i.e. asset specificity, will presumably lose some, or maybe all their productivity, if the relationship breaks and the resources must find new, alternative "employment". This changes the economic rationales dramatically!

Traditional market economy axioms are rooted in the concept of a world without the kind of disturbances and irregularities that relationships tend to create and which tend to lead to relationships. So, the traditional pure exchange view is like a false mirror as it does not reflect what is going on in everyday business life. Relationships matter and therefore we have to express them in market-economic terms:

	The traditional marketing concept	The relationship marketing concept
Resource mobility	Complete – no asset specificity	Incomplete – asset specificity
Exchange friction	No friction between parties	Friction causing costs
Time frame dimension	Periodic short term view	Customer life cycle long term view

Figure 3-1: Principles of relationship marketing economics

Consider slogans like "the customer comes first" or "customers make pay-days possible" or "we try harder". These catch phrases are not just clichés, but are expressions that reflect the vision, values and corporate identity of a company. And they build on a customer relationship philosophy and not on a pure exchange perspective.

The Principle of Complete Resource Mobility

Complete mobility of resources means that a company can move its capacities and resources from one area of application or one type of customer to new purposes and other customers without any loss of return on such assets. The behaviour of the supplier and the customer is therefore not supposed to be influenced by resource mobility considerations such as a customer trying to unilaterally improve the bargaining power because of the supplier's specified assets or a supplier wishing to impose control over and create switching costs for its customers.

Additionally, it may be assumed that all companies have access to the same bundles of resources on the factor market, which then means that competitive advantages cannot be gained through unique resource combinations or core competencies.

The classic, well-accepted framework for marketing thinking maintains that sustainable competitive advantages are created by the capability of a company to exploit market opportunities better, cheaper, faster or more focused than its competitors, sometimes called the *s-c-p axiom* for structure

(exploration), conduct (exploitation), and performance (execution).

The principle of market leadership based on a unique ability to build and defend long-term, mutually beneficial customer relationships more effectively than the competition represents the opposite view, i.e. that the resources and competencies generating the leading position on the market can neither be easily copied nor acquired on the factor market.

Relationship-based market leadership may impose a risk of dependence to the extent that the relationship competencies rely on customisation of assets to satisfy individual customer demands. Specified assets may be less valuable for other customers and hence such a trade structure requires particular protection measures via contractual mechanisms. The exchange view does not offer an explanation of this phenomenon.

Relationship economic thinking treats the economic value of an investment in customer specific assets up against the risks, which will inevitably follow. The classic marketing concept does not address this dilemma.

The Principle of Frictionless Transactions Between Supplier and Customer

In traditional business economics, it is assumed that the total, real price of a good or a service equals the sum of the costs consumed in production and distribution etc. This perception of total costs does not include the relational context of the production and procurement process. The traditional costing principle ignores that the *mere way of organising an activity,* i.e. producing versus buying, is in fact itself a key driver of costs.

Implicitly, this principle of frictionless transactions assumes that the only alternative to internal activity and hence the organisational hierarchy as the regulating mechanism between supplier and user is the *market exchange contract.* According to the idea of the classical market contract, a buyer can eliminate his or her risk, get the lowest price and obtain

full transparency by an all-included contractual arrangement, such as a bill of lading in sea transportation.

But the real world is far from frictionless, when it comes to inter-firm activity. Where transactions are relationship-based, a completely new category of costs and benefits arises. The relationship is a *hybrid* kind of activity in between the perfect world of the classic external market contract and the smooth in-house production. The in-house production assumes mutual confidence between the transacting parties who are all members of the same organisation and under the same hierarchical umbrella. In hierarchies like corporate organisations, individuals are supposed to obey. Hence, the frictions are supposed to be at a minimum, although realities are often somewhat different from this ideal depending on factors such as reward mechanisms, corporate policies etc. Frictions are also supposed to be minimal using the market contract as regulating mechanism, but for the opposite reason, namely that the parties have agreed on a formal arrangement, by which they anticipate every possible situation and outcome.

Most economic activity does not live up to the *frictionless ideal* of either the intra-organisation exchange or the transparent market contract. The modified market mechanisms in the form of relationships introduce the costs of friction between two economic spheres. Managing the costs and benefits arising from those frictions between a buyer and a seller more efficiently than competitors then becomes a crucial strategic issue.

The Principle of the Period as Fiscal Dimension

For well-known reasons the period (year, quarter or month) is the key measurement interval in financial management and therefore also the vehicle in marketing management as well. The single time period can, however, only to some extent include the dynamics and the cause-effect mechanisms in market processes.

The Attention-Interest-Desire-Action effect hierarchy communications model (AIDA) is a good example. Costs

of communication (creating attention) are paid in period x, whereas the outcome in terms of revenues (creating action) often materialises in period x++ (although difficult to measure with reasonable certainty).

Relationships between supplier and customer go through different stages over its lifetime. In this way, the most and maybe the only relevant economic approach to marketing from a relationship perspective is the principle of lifetime value of relationships and how it can be influenced by whom and when.

In recent years, interest in measuring relationship value has increased. One study concluded e.g. that every new pizza customer on average represented an amazingly high net present value of USD 5,000.

The lifetime perspective is not a revolutionary discovery. Most business people would agree to the economic importance of relationship elasticities such as volume, price, churn and duration. What people must find perplexing is that there is a desperate need for reliable theories and measurement tools in this area.

In the following sections, an overview of the core principles in the business economics of customer relationships will be presented.

3.2 The Business Economics of Customer Relationships – Risk and Opportunism

Research has demonstrated that the mere planning, execution and monitoring of customer transactions per se drives 25% of all costs in an average company – the price of "running the economic system".[30] Furthermore, several case studies have found a significant positive correlation between the durability of customer relationships and profitability. One study[31] e.g. concluded that a company, depending on the industry, could potentially increase the net present value of a customer relationship by 35-95% if reducing the churn rate by 5%. Although other studies have reached the opposite conclusion

that old customers (business to business) tend to be less than average profitable, there is no doubt that the relationship dimension plays an important role as economic driver in the customer as well at the supplier organisation.

The phrase saying that it "costs ten times less to sell more to existing customers than to sell the same amount to new customers" is true in most situations, revealing the *acquisition economics* versus the *retention economics* dichotomy.

The following real-life story illustrates the importance of customer relationship economics.

Skanska and Rockwool[32]

Skanska is an international construction company with offices worldwide and a strong position in Sweden. Skanska is managed according to decentralised principles. Therefore, local managers, including the purchasing managers, make all day-to-day decisions.

Rockwool produces insulation materials of mineral wool and Skanska is one of Rockwool's biggest and most important customers.

Both Skanska and Rockwool operate on extremely competitive markets characterised by low margins and constant price pressure, where even minor deviations, delays or miscalculations can eliminate all profits from a given project. Some years ago, Skanska and Rockwool entered into a cooperative contract with each other with the explicit purpose of optimising the economics of the trade between them. In other words, Skanska and Rockwool aimed at replacing traditional exchange-centric thinking with relationship market economics.

The managerial motives for a switch from exchange to relationship terms of trade are illustrated in figure 3-2.

Before the relationship-based contracting was established, Skanska handled the purchase of insulation materials from project to project, most often in bid rounds where the suppliers of insulation, being a quite homogenous commodity, were played out against each other.

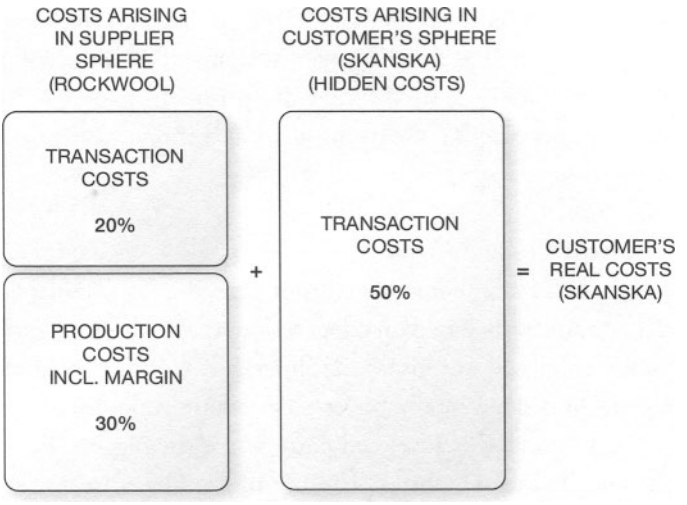

Figure 3-2: Skanska and Rockwool in the before-situation: The real costs of mineral wool at the arrival to the site. Source: Heikkila (1996)

This behaviour led to the astonishing cost structure shown in figure 3-2 above, which the parties to their surprise discovered, when they mutually decided to open their books in a joint analysis. The total costs arising in the supplier's, i.e. Rockwool's sphere, amounted to no more than 50% of the total price, Skanska actually paid. Series of hidden costs, such as inventory costs, loading and unloading, transportation, waste, loss, theft, delays of deliveries, broken deal costs and administration should be added to get a true picture of the business economic price.

The core production and administration expenses amounted to less than 25% of the total costs. The driver behind the remaining expenses was the frictions caused by the exchange-centric terms of trade.

In the pre-relationship situation, both parties pursued a *monadic*, sub-optimising objective, making use of the classical market contract. The monadic motivation is the opposite of the dyadic joint-optimising approach as introduced in Chapter 1.

The outcome was opposite from the intention of both par-

ties, i.e. a dramatic rise in the price of insulation materials for the seller as well as for the buyer in terms of extremely high transaction costs, a subtle kind of "prisoners' game" where both opponents play a win-lose game and end up with a lose-lose result.

The True Product Costs

Even when a supplier and a customer develop an interdependent relationship based on cooperation, the rivalry within the relationship will not disappear altogether. Conflicts of interest are embedded in any buyer-seller relationship despite the strategic match, because each party wants the biggest slice of the pie. Therefore, the probability of conflict arises in any case. But it is not necessarily a zero-sum game!

The Skanska-Rockwool case shows the true costs of a sales or purchase exchange in business economic terms and not from an accounting angle, which is:

$$\textit{total costs} = \textit{product price} + \textit{transaction costs}$$

In hindsight, it appears to be sound business logic for Rockwool to promote a relationship-economic, co-operative marketing approach, as the end result happened to be a win-win situation. Although it seems obvious and in the interest of both parties to mutually drive down the exorbitant friction costs stemming from *idiosyncratic behaviour,* where you are very conscious not to let your opponent become too influential, buyers and sellers rarely agree to just "open the books" with the idea of chasing joint optimisation and deepening the relationship. Instead, management most often prefers to stick to a pure or slightly modified market contract, as this regulating mechanism is considered to offer a maximum safeguard of self-interest, transparency and bargaining position.

As soon as the market contract is replaced by the hybrid relational contract, elements of risk and insecurity arise. The relationship contract contains a consciously chosen risk element, where the parties agree on a certain level of manoeu-

vrability and where confidence plays a key role as well. Risk is the cost, whereas saved transaction costs are the benefit.

Risk is revealed via *opportunism*, which is the flip side of the coin in any relationship. Opportunism means that a party, buyer or seller, will exploit and manipulate a situation to gain unilateral benefits at the expense of the counterpart. Opportunism can even stretch into what can be called "legal theft" in many bargaining processes.

The opportunity of developing "mutual benefits", which is an integral part of our relationship marketing definition, does not rest on idealism, but on a mere business self-interest calculation. What are the pros and cons of relationship contracts, balancing the benefits against the risks of the counterpart or perhaps one's own opportunism? Additionally, no decision-maker is completely rational or in possession of all information regarding alternatives and consequences.

Two kinds of risk are at play in any relationship. *Out-there risk* is caused by disturbances externally of the relationship, whereas opportunism in the relationship or expected opportunism leads to *in-here risk*. The opportunism and insecurity embedded in any relationship create idiosyncrasy and hence increase the costs, because they stimulate protection mechanisms. Ultimately, these protection mechanisms threaten the competitiveness of the relationship. So, for either party there is also the ongoing trade-off between the cost of risk and the cost of insurance through safeguard mechanisms.

The dyadic motive as opposed to the monadic motive, as touched upon previously, means that the buyer and the seller make systematic attempts to optimise the relationship by taking the interests of the other party into consideration as a matter of self-interest. The basic concept behind the dyadic approach is that a marketer should plan and execute such actions that minimise the customer's total costs, including the savings following managed frictional reductions. As demonstrated, this is not only a pricing issue. The contractual form of the relationship and the governing principles are equally important. Dyadic marketing concentrates on the overall

relationship-economic cost-benefit balance within a competitive perspective. The ability to understand the game and the way cards are distributed in that game enables a player to define the best possible strategy for himself.

The *triadic* situation[33] includes the threats and opportunities stemming from the present or the potential relationships between a company's customers and its competitors.[34]

Risk and opportunism are guidelines for understanding and navigating through the mechanisms that are the basic concepts behind relationship marketing. The key economic expression is the transaction costs arising from the relationship parameters.

3.3 Customisation of Assets, Frictions and the Life Cycle

As mentioned earlier, customised assets or asset specificity[35] refer to the situation where an asset represents a lower economic value for a company in alternative employments than for the actual customer(s). Assets, which have been adapted to only one individual customer or application, have a positive impact on the relationship economy in that specific customer relationship. Customisation must be dealt with as a focal point and a crucial parameter in relationship strategies. Customisation of assets in that respect is in contrast to the idea of complete resource mobility in traditional business economics.

Customisation of Assets

Asset customisation can ultimately bring a supplier and his or her customer closer together. Consider the manufacturing company that invests in dozens of manufacturing plants, all working as subcontractors for only one customer. This is often the situation in relation to consumer goods, where leading firms like Coca-Cola, McDonalds and Marks & Spencer create a one-to-one sole supplier relationship with value subcontractors or partners.

The same level of *symbiotic relationships* can also be found in the relationship between airlines and handling agents and airline caterers or between newspapers and printing houses and in many other situations.

Dedicated, customised resources contribute to rationalise, protect and cost reduce the buyer-seller interaction; they create profitability for both sides and impose entry barriers for competitors and substitutes. Imagine what would happen if McDonalds decided to buy potatoes on the spot market every morning instead of contracting with manufacturers processing the potatoes on a long term basis. Any manufacturer that would offer an attractive price to McDonalds for a short-term deal would hardly succeed in breaking into the existing relationships.

Asset specificity can be a powerful marketing tool, but it also induces a high risk and an incentive to opportunism. Large companies very often have one sole or preferred supplier plus a second source. The idea is that the second source absorbs above peak capacity situations at the prime source, while at the same time safeguarding the customer company against supplier opportunism or bankruptcy. If assets like equipment, staff, sites or intellectual property rights are tailor-made to this specific important customer, the supplier is potentially vulnerable if the customer has a nearby alternative solution available.

Not all products or services that are perceived as customised within a certain range of features are individualised. *Mass customisation* does not imply the same level of risk and opportunism as previously described. Restaurants prepare the meal according to the taste of the guest without customising any asset. Car manufactures do the same when the customers choose an individual mix of design, colour and accessories.

Cost of Frictions

The Skanska-Rockwool example above illustrates how buying behaviour based on a market contract paradigm can lead to frictions in the physical and in the administrative system and

hence also becomes generator of considerable and unnecessary costs. Frictions are derived from idiosyncratic reactions. The rational buyer assumes that optimal buying behaviour means using the market for each exchange, because any special preference for a supplier will be exploited by that supplier. Competitive pressure is what presumably prevents a supplier from excess pricing and term-twisting. Therefore, both parties must live with the frictional costs. The costs of idiosyncrasy are expected to be more than offset by lower prices. Markets are expected to be perfect or at least close to perfect.

In business-to-business relationships, it has become quite usual to distinguish between the *phase of negotiation* and the *phase of delivery.* During the purchasing phase, the market mechanisms are active. Existing relationship contracts are being stalled. Both parties act, and react, idiosyncratically; they distrust the motives, statements and calculations of counterparts. When an agreement has been reached, the parties enter into the phase of implementation. Both the seller and the buyer have an interest in minimising the frictions in processes like order flow, documentation, quality control, exchange of information and corrective actions if requested by the other party. The relationship is an in-between, hybrid, regulating structure and in many respects more complex to manage than the market contract or the hierarchy. Competition forces companies to concentrate on core skills only. This has created a demand for new management qualities, because the patterns of relationships change and become much more important. Whereas the idea of identifying and nursing a company's core competencies has become strategic mantra, the business economic discipline derived from that, i.e. to establish and administer customer and supplier relationships with a minimum of frictional costs, then becomes the key to competitive advantage.

Customer Life Cycle

The product life cycle and its underlying diffusion of innovation curve is the ancestor of most conventional marketing

strategy models from the BCG[36] matrix to Porterian thinking and crossing the chasm fascination. The composition of a company's marketing programmes, in the form of the 4 Ps, changes over the product life cycle because of market segments' attractiveness and competition.

All products, product categories and industries tend to follow the bell formed development curve from birth to death. The same pattern can be observed for customer relationships as well. In that respect, the customer life cycle or CLC becomes the framework for the formulation of marketing programme prescriptions and of understanding the business economics of relationships from a lifetime perspective. In contrast to the period as the time interval in programme formulation and in impact measurement, the CLC relies on a much more dynamic, cause-effect and customer-oriented view of economics and marketing management. One possible representation of the CLC concept is shown in figure 3-3.[37]

A customer relationship goes through different stages from its emergence to late stage struggling and final dissolution. In between, the relationship will develop as a consequence of the rational behaviour of both supplier and customer. At the ma-

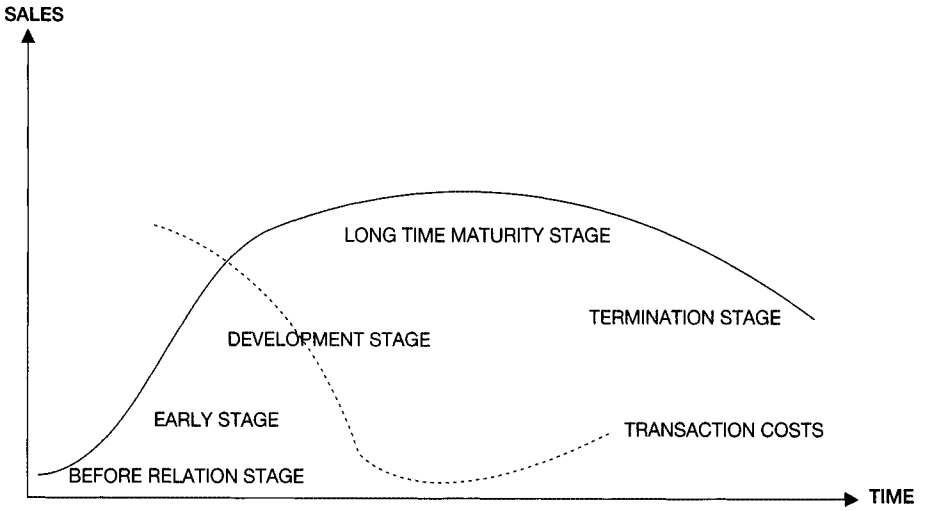

Figure 3-3: The customer life cycle

turity stage, the first signs of fatigue and restriction become apparent. Of course, points of disruption and cut-off will arise during the lifetime. Many customers e.g. simply reject to "marry" and break out in the meeting with the relationship chasm as a matter of policy.

In figure 3-3, we also illustrate how the transaction costs develop over the CLC. Initially, the idiosyncrasy, then trust and mutual adaption-driven cost reduction to final increase when unilateral incentives may eventually become the stronger ones.

The customer life cycle indicates the existence of four different concepts in relationship economics:

- Acquisition economics at the pre-relationship stage.
- Penetration economics at the early and the development stage.
- Retention economics at the long-term-/maturity stage.
- Termination economics at the end of the customer life cycle.

The economic calculations and the marketing tasks differ across the generic stages of the customer life cycle. At the pre-relationship stage, a company must invest time and effort to convince the customer to make a trial purchase, change supplier, take in a second source or buy a project. The costs of lost deals must be included as well. At the stage of acquisition, canvass sales, promotion, low margin orders, pilot installations and broken deal costs dominate. The headline is acquisition economics.

When a relationship has been established, the supplier mill move on to gain momentum with the customer in terms of time frame contracts, cross selling, share of pocket etc. The penetration-economic stages involve staff costs, solution development, product modification, but not rarely direct financial cash contributions to the customer organisation e.g. to buy shelf space and attention.

At the maturity stage, which may vary from weeks to decades depending on the situation, retention-economic considerations may be about prices and margins, costs of keeping competitors' entry barriers high, further product development etc.

Dissoluting a relationship can be rather expensive. Claims occur. Escrows and guarantees must be either cancelled or distributed. Some assets and employees may become idle which may result in new, partly unanticipated expenses.

It is reasonable to believe that the margin of profitability will increase (most apparent in business-to-consumer relationships) and that transaction costs will decline over the customer life cycle as a function of time, experience, confidence and possibly adaptation of assets. Some of the main factors supporting the idea of increasing returns over the customer life cycle can be summarised in a few headlines:

- High transaction costs at the beginning of the life cycle ("bargaining/pre-relationship") where monadic motives still dominate.
- Anticipation of opportunism and high costs of control as the market mechanisms still regulate the trade between seller and buyer. Hence prices are also lower.
- Higher costs of service, administration and mistakes at the earlier stages.
- Add-on revenues in terms of cross-selling, increase in volume and product line extension assume mutual confidence.

The customer relationship-profitability curve reflects a similar path.

A company may get stuck if, for some reason, the customer breaks off the relationship before or just after the CLC break-even point. Retention economics in terms of prolongation of the life cycle and other kinds of add-on revenue streams then

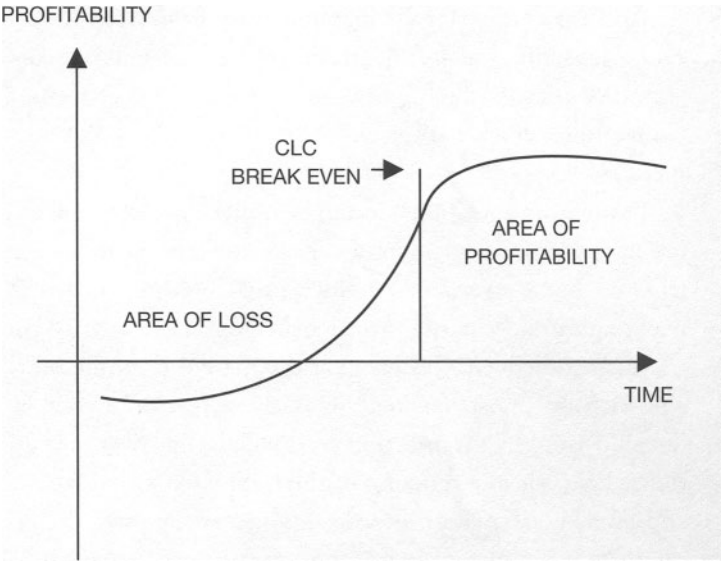

Figure 3-4: The customer relationship-profitability curve

become a key factor to understanding and improving overall performance.

Customer life cycle and relationship-economic coherence varies across industries. Some industries have extremely high entrance costs to relationships in terms of customised assets. This is the case with shipbuilding, heavy construction and in great many subcontractor industries, e.g. components to aircraft manufacturers etc. Often the CLC break-even point will be passed at a relatively late stage and profitability depends entirely on the marketing efficiency of the customer, e.g. the number of aircrafts of a given type being sold over the lifetime of the specific model. The same will be the case in industries with high customer acquisition costs such as in banking, insurance or asset management, where suppliers must invest in order to gain customer trust.

In other industries, which are also characterised by made-to-order and asset customisation, there will be no or at least very low expectations of continuity and life cycle. The marketing strategy must therefore be exchange-oriented and de-

liver profitability on the first order and on every order after this. In industries such as home construction, travel or some segments of consulting this will be the case.

Although relationship marketing focuses on acquisition as well as development and retention strategies, the element of retention value is often given more prominence. Indeed, it has become one of the underlying assumptions of relationship marketing that it encourages *retention economic rationales* first and *acquisition marketing* second. This bias exists because the relationship aspect is considered to be particularly beneficial on mature markets, which constitutes a vast majority of marketing situations. Also, the industries chosen most frequently as examples of successful application of customer retention strategies appear to have high front-end costs (selling costs) embedded in their business system.

3.4 Generic Transaction Costs

Customised assets, frictions and the "law" of the customer life cycle in the physical business system altogether are the drivers of transaction costs in the economic system. Perceptions of risk and opportunism determine how far two parties are willing to go in order to reduce frictions and develop a relationship that is based on interdependence. Relationship marketing develops competitive advantage by creating relationship-economic value and by inducing transaction benefits. Whereas the four economic concepts just described are built into the stages of the customer life cycle, so to speak, we must also pay attention to some basic generic types of transaction costs – not being attached to a specific lifetime situation.

The transaction cost basket is composed of the amount of money the buyer and the seller must pay in addition to the cost of the core service in order to execute the deal as illustrated in the Rockwool-Skanska case. There are three different types of transaction costs: Pre-exchange costs arising during the information-gathering stage, arrangement costs arising during negotiation and decision and post-exchange

costs in terms of implementation and monitoring expenses. These are the *3 Cs of transaction costs: Contact, Contract and Control costs.* In principle, any exchange carried out by two parties at any of the life cycle stages imply a certain amount and mix of transaction costs.

How the underlying mechanisms in a *physical system* are the drivers of transaction costs in the *economic system* is summarised in figure 3-5.

	Contact Costs	Contract Costs	Control Costs
Acquisition economic stage	High	High	High
Penetration economic stage	High	High	Medium
Retention economic stage	Low	Low	Medium
Termination economic stage	High	Medium	High

Figure 3-5: Transaction costs across the economic life cycle stages

The qualitative transaction cost levels indicated in fig. 3-5 are approximations of an "average" CLS and are in accordance with the cost curve in fig. 3-3. Of course, the reality of business life is not that simple.